

There's No Free Lunch

Economic Tradeoffs are a Fact of Life

By Tod Ginnis

Closing sweatshops. Eliminating pollution. Expanding home ownership. Higher unemployment benefits. Setting aside more land for parks. What kind of cruel person would oppose such feel good policies?

The truth is, nothing comes without a cost. Sometimes the person enjoying a benefit doesn't pay for it directly. But as economist Harley Lutz said, "Until man acquires the power of creation, someone will always have to pay for a free lunch." The questions to ask are who's paying, and how much. And of course, whether it's worth it.

Somebody always pays the tab. When a price is too low (or "free") for the consumer, demand is artificially high. Rationing or shortages inevitably follow. Ask anyone who grew up in the Soviet Union. Many staple items were extremely cheap, but after waiting in line for hours, you would often find they were out of stock. Of course, if you had foreign currency you could buy them on the black market at much higher prices...in other words, their true value.

Whether you realize it or not, every decision you make in life is a tradeoff between costs and benefits, or risks and rewards. Sometimes it's obvious: do you spend \$1500 for a new big screen TV? It depends on what's more important to you, the \$1500 or the benefits you expect from the TV. You might consider your financial situation, whether your current TV is adequate, how important TV is to you, etc. There are many factors, and their importance varies greatly from person to person.

It's About Being a Grown-up

Ignoring tradeoffs is a childlike notion. Little kids can't grasp the concept: they want what they want when they want it. The fact that if they get one thing they want (a trip to Disney World Saturday) means they can't have something else they want (their friend's pool party Saturday) is beyond them.

Many adults express similar childlike notions. They support severe restrictions on development in San Francisco. Then they demand affordable housing, which is impossible as the restrictions they support push land prices to dizzying heights.

Every policy includes tradeoffs. If the politicians designing the policies don't understand or don't care about the tradeoffs, the policies will almost certainly not achieve their goals.

We would laugh at someone who denied gravity, but the idea that major decisions don't involve tradeoffs is equally silly. Early in the Clinton administration, I didn't know much about Al Gore. Then he said in a speech, "There can be no tradeoffs when it comes to the environment." That is a staggering statement. Taken to its logical extreme it means taxpayers should spend \$100 billion to save a tree. I decided I could place the new VP into one of three categories:

- A. He was an environmental fanatic.
- B. He was operating on a childlike level.
- C. He knew his statement was silly, but was ingratiating himself to environmentalists.

Let's look at some examples of how tradeoffs work in the real world. And we'll see the cost of ignoring them:

Kathie Lee, Lifesaver

Outside of your own life, tradeoffs aren't always so clear. Many cheered in 1996 when Kathie Lee Gifford's clothing line fired its Central American sub-contractor found to be using underage "sweatshop" labor. The activists who created a public furor in the U.S. patted themselves on the back and moved onto their next cause. But what about the Honduran workers?

Few people want their 12-year-old children working. Kids should be going to school and playing with their friends. In developing countries, many children must work if the family is to avoid starvation. When the population is more prosperous, that tradeoff won't be necessary. But until that time, I'm betting that making Kathie Lee Casuals was more pleasant for these kids than prostitution or starvation. Without the Kathie Lees of the world, many children face that horrific choice.

Felix Unger vs. Oscar Madison

Surely, nobody is pro-pollution. The cleaner the better, right? Not exactly. True, we don't want to be stepping through garbage and inhaling thick smoke every time we walk outside. On the other hand, clearing away every stray piece of trash and creating zero-polluting factories would be prohibitively expensive. Taxes and unemployment would skyrocket. There is a balance (or tradeoff) between aesthetics, health risks, and costs. And this balance varies by location based on culture, wealth, and other factors. After a certain point, it isn't worthwhile to spend more money to remove small amounts of pollution. Economists call this diminishing marginal returns.

Lawsuit Lottery

We've all heard stories of high jury awards for minor infractions. Then there are the cases where a blameless person (say a doctor) pays for a tragic outcome beyond his control. Some of us laugh. Some shake our heads in disgust. And others say, "Make the rich guy pay!" But who really picks up the tab?

Every firm factors the cost of lawsuits and insurance into its business plan. So in the end, the customers, employees, or owners get the bill. In some parts of the U.S. malpractice insurance for OB/GYN doctors has become so costly that many have relocated or left the profession. Do the pregnant women driving three hours to see a doctor know where to place the blame?

The lawsuit lottery is similar to an ordinary lottery in that the vast majority of losers pay off the few winners. But there's one important difference: in a regular lottery, each of us can choose whether we want to play, and how much we put at risk. Since the cost of lawsuits and liability insurance is embedded in almost everything we buy, we're all forced to play the game.

Fannie and Freddie: "Helping" Us Into the Mortgage Mess

Fannie Mae and Freddie Mac buy mortgages from banks and other lenders to help free up lending resources and expand home ownership. When you take out a mortgage there's a good chance your lender immediately packages it with many others and sells it to one of the quasi-government giants.

In the days of the Bailey Brothers Building & Loan, bankers knew their customers. Since it was the bank's own money on the line, they were concerned that borrowers were reliable and would likely repay the loan. But when banks immediately ship your loan to someone else, they don't care who you are. They only care if you can pay their upfront fees.

Lenders are required to ensure that your finances meet Fannie or Freddie's minimum requirements, but social engineers in Congress have lowered the requirements to ensure more low-income people own homes. Fannie and Freddie played along, as more business for them meant higher stock prices and hefty executive bonuses.

When a bank can offer a mortgage with an extremely low down payment and immediately sell it off, there is tremendous incentive for fraud by both lenders and borrowers. Lenders collect their fees and take no risk, while borrowers buy a house they can't afford. When the housing market is strong, these borrowers quickly resell or "flip" their homes for a profit. When the market declines, they simply walk away and leave Fannie or Freddie (and now taxpayers) holding the bag. That's called a free option (heads I win, tails you lose). And free options never work out well for those selling them...in this case that would be Fannie and Freddie.

Expand Unemployment Insurance: a Political No-Brainer

Unemployment insurance is in the news frequently during economic downturns. We must raise the benefit. Why don't we let people stay on longer...or indefinitely? You'll rarely see Democrats or Republicans opposing expansion of unemployment benefits. And most voters are on board. But is it always a good idea?

Most Americans support a government-provided social safety net, albeit to varying degrees. I don't want to debate that issue here. What I do want to bring up is a recognition of tradeoffs. Have you ever heard someone say, "I'll start really looking for a job when my unemployment runs out"? Most of us would rather be working than sitting at home collecting a smaller check. But some people at lower income levels conclude that working is not worth it when someone will take care of their basic needs for free. When the government says, "If you still don't have a job we'll pay you for another 13 weeks," some won't look for a job, or will refuse work they consider "beneath" them. And the unskilled workers who make this decision are exactly the ones who need job experience to drag themselves out of poverty.

Every time government raises the amount or extends the period of unemployment benefits, it decreases the incentive for some people to find a job...or accept a less appealing one. Absent any benefits, more people would be working. Generous benefits discourage some people from taking jobs. To deny this is to ignore human nature: some people are lazy and will always take the easy way out. We may decide as a society that the tradeoff is worthwhile. But just because it's difficult to measure the exact cost doesn't mean it isn't real.

These are just a few examples. Every decision we make includes tradeoffs: should we have children? Will I take a vacation? When should I retire? Absent tradeoffs and how we value them, we would all be living identical lives. But when it comes to public policy, many people ignore the entire concept. And that's very dangerous. As P.J. O'Rourke famously said, "If you think health care is expensive now, just wait until it is free."

Tod Ginnis is a freelance writer and financial consultant "Helping Wall Street Speak to Main Street." Feel free to drop him a line at (201) 433 – 6630 or tginnis@comcast.net to discuss how he might support your communications efforts. Tod's web site is www.TodGinnis.com, and his blog is www.NoSweatEconomics.com.